

MONTANA STATE FUND 2006 ANNUAL REPORT



Statutory Financial Statements



2006 ANNUAL REPORT

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STATUTORY STATEMENTS OF ADMITTED ASSETS, LIABILITIES, AND EQUITY as of June 30,

ADMITTED ASSETS

	2006	2005
INVESTMENTS		
Bonds	\$ 668,698,440	\$ 565,851,046
Equity Securities	83,377,362	76,737,097
Cash and Short-Term Investments	14,919,072	32,157,356
Other Investments - Collateral Securities on Loan	132,438,892	101,859,456
Total Investments and Cash	899,433,766	776,604,955
OTHER ADMITTED ASSETS		
Premium Receivables	11,592,290	9,655,653
Equipment (net)	1,266,139	786,673
Interest Receivable	9,466,862	8,206,869
Other Assets	15,771,861	6,569,389
Total Admitted Assets	<u>\$ 937,530,918</u>	<u>\$ 801,823,539</u>

LIABILITIES AND EQUITY

LIABILITIES		
Losses Incurred Reserves	\$ 535,114,000	\$ 464,564,000
Loss Adjustment Expense Reserves	55,574,000	46,993,000
Liability for Securities on Loan	132,438,892	101,859,456
Deferred Revenue	2,106,613	4,925,828
Other Liabilities	49,195,918	35,127,384
Total Liabilities	774,429,423	653,469,668
CONTINGENCIES AND SUBSEQUENT EVENTS		
EQUITY		
Policyholders' Equity	163,101,495	148,353,871
Total Liabilities and Equity	<u>\$ 937,530,918</u>	<u>\$ 801,823,539</u>



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STATUTORY STATEMENTS OF REVENUE AND EXPENSES AND CHANGES IN EQUITY for the years ended June 30,

	2006	2005
Net Premium Earned	\$ 211,892,198	\$ 189,378,858
Losses Incurred	(180,614,395)	(152,545,131)
Loss Expenses Incurred	(25,223,629)	(20,185,786)
Underwriting Expenses Incurred	(19,344,047)	(21,638,784)
Net Underwriting Loss	(13,289,873)	(4,990,843)
Net Investment Income Earned	32,440,146	29,125,416
Net Realized Capital Gains (Losses)	(255,892)	1,041,886
Premium Balances Charged Off	(2,791,527)	(843,697)
Other Expenses	(981,233)	(496,036)
Net Income Before Dividends	15,121,621	23,836,726
Policyholder Dividends	(5,001,042)	(5,004,416)
Net Income After Dividends	10,120,579	18,832,310
Prior Year End Equity	148,353,871	127,492,156
Net Unrealized Gains on Equity Securities	6,640,265	4,598,723
Change in Non-admitted Assets	(2,012,516)	(2,522,786)
Aggregate Write In for Other Losses	(704)	(46,532)
END OF PERIOD EQUITY	\$ 163,101,495	\$ 148,353,871



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STATUTORY STATEMENTS OF CASH FLOWS for the years ended June 30,

	2006	2005
CASH FLOWS FROM OPERATIONS		
Premiums Collected Net of Reinsurance	\$ 214,435,780	\$ 188,037,127
Loss and Loss Adjustment Expenses Paid	(126,707,024)	(113,288,917)
Underwriting Expenses Paid	(27,017,078)	(25,803,577)
Cash Provided by Underwriting	60,711,678	48,944,633
Net Investment Income	30,657,767	29,754,246
Other Income (Expenses):		
Agents' Balances Charged Off	(2,791,527)	(843,697)
Net Amount Withheld or Retained for Account of Others	9,064,114	4,541,922
Miscellaneous Income (Expense)	61,139	51,368
Cash Provided by Other Income (Expense)	6,333,726	3,749,593
Dividends to Policyholders	(5,001,042)	(5,004,416)
Net Cash Provided by Operations	92,702,129	77,444,056
CASH FLOWS FROM INVESTMENTS		
Proceeds from Investments Sold, Matured or Repaid:		
Bonds	87,105,705	91,939,366
Collateral and Equity Securities	5,613,768	2,438,833
Total Investment Proceeds	92,719,473	94,378,199
Cost of Investments Acquired (long-term only):		
Bonds	(194,362,049)	(155,380,802)
Collateral and Equity Securities	(5,216,110)	(2,247,180)
Cost of Investment Acquired	(199,578,159)	(157,627,982)
Net Cash Used For Investments	(106,858,686)	(63,249,783)
CASH FLOWS FROM FINANCING AND MISCELLANEOUS SOURCES		
Cash Provided or (Applied):		
Purchases of Equipment	(3,109,880)	(2,721,963)
Other Applications	28,153	-
Net Cash Used for Financing and Miscellaneous Sources	(3,081,727)	(2,721,963)
NET INCREASE (DECREASE) IN CASH AND SHORT TERM INVESTMENTS	(17,238,284)	11,472,310
CASH AND SHORT TERM INVESTMENTS - BEGINNING OF YEAR	32,157,356	20,685,046
CASH AND SHORT TERM INVESTMENTS - END OF YEAR	\$ 14,919,072	\$ 32,157,356

The accompanying notes are an integral part of these financial statements.

**NOTE A – ORGANIZATION, BASIS OF PRESENTATION, AND SUMMARY OF
SIGNIFICANT ACCOUNTING POLICIES**

1. Organization

The Montana State Fund (MSF) is a nonprofit, quasi-public entity established under Title 39, Chapter 71 of the Montana Code Annotated (MCA). MSF provides Montana employers with an option for workers' compensation and occupational disease insurance and guarantees available coverage for all employers in Montana. MSF is governed by a seven member Board of Directors appointed by the Governor. MSF is a component unit of the State of Montana. MSF is attached to the State of Montana, Department of Administration for administrative purposes only. MSF governs, operates and completes its financial reporting as an insurance company domiciled in the State of Montana.

MSF functions as an autonomous insurance entity supported solely from its own revenues. All assets, debts, and obligations of MSF are separate and distinct from assets, debts, and obligations of the State of Montana. State law requires MSF to set premiums at least annually at a level sufficient to ensure adequate funding of the insurance program during the period the rates will be in effect. If MSF is dissolved by an act of law, the money in MSF is subject to the disposition provided by the legislature enacting the dissolution with due regard given to obligations incurred and existing (Section 39-71-2322, MCA).

During the 1990 Montana Special Legislative Session, legislation passed establishing separate funding and accounts for claims of injuries resulting from accidents occurring before July 1, 1990, referred to as the Old Fund, and claims occurring on or after July 1, 1990, referred to as the New Fund (MSF). This report reflects only the operations of the Montana State Fund (New Fund only). MSF administers and manages the remaining claims of the Old Fund on behalf of the State of Montana and receives an administrative fee.

During the 2003 Montana Legislature, statute (Section 39-71-2352) was changed in regards to Old Fund transfers of equity. As a result, any excess of Old Fund equity is to be transferred to the State of Montana General Fund rather than to MSF.

2. Basis of Presentation

The accompanying financial statements of MSF have been prepared in conformity with accounting practices prescribed and permitted by the State of Montana Department of Insurance. Such practices vary from accounting principles generally accepted in the United States of America (GAAP) principally in that certain assets reportable under GAAP are "non-admitted" and have been excluded from the accompanying statutory statements of admitted assets, liabilities and equity and charged directly to net worth and that certain investments which would be carried at estimated fair value under GAAP are carried at amortized cost.

NOTE A – ORGANIZATION, BASIS OF PRESENTATION, AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, *continued*

2. Basis of Presentation, *continued*

The State of Montana Department of Insurance recognizes only statutory accounting practices prescribed or permitted by the State of Montana for determining and reporting the financial condition and results of operations of an insurance company. The National Association of Insurance Commissioners' (NAIC) *Accounting Practices and Procedures* manual (NAIC SAP) has been adopted as a component of prescribed or permitted practices by the State of Montana.

MSF's net income (loss) and equity as stated on a NAIC SAP basis and on the basis of practices prescribed or permitted by the State of Montana are the same at June 30, 2006 and 2005.

The Montana Code Annotated references conformity with the Accounting Practices and Procedures Manual within section 33-2-701(1) and therefore concludes that no legislation is necessary to adopt its use.

3. Significant Accounting Policies

Cash and Cash Equivalents – Cash constitutes a medium of exchange that a bank or other similar financial institution will accept for deposit and allow an immediate credit to the depositor's account. Also classified as cash are savings accounts, certificates of deposits with maturity dates of one year or less, and cash equivalents. Cash equivalents are: investments with original maturities of three months or less; are readily convertible to known amounts of cash; and, present insignificant risk of change in value due to changes in interest rates. The Montana State Treasury holds MSF's cash and cash equivalent balances.

Short-term Investments – Short-term investments are those investments with remaining maturities of one year or less at the time of acquisition, excluding those investments classified as cash equivalents. Short-term investments include but are not limited to, bonds, commercial paper, money market instruments, repurchase agreements, and collateral and mortgage loans that meet the above criteria.

Bonds and Equity Securities – Equity securities, bonds and certificates of deposit with original maturities greater than one year are long-term investment securities. Long-term securities are held by the Montana Board of Investments (BOI) and State Street Bank is the custodial bank for the BOI.

Equity securities are valued at fair market value. The Montana Constitution allows investing in equity securities, with the restriction that equity securities cannot exceed 25% of total investment book value. The BOI approved a policy statement to keep equities in the 8% to 12% range.

continued

NOTE A – ORGANIZATION, BASIS OF PRESENTATION, AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, *continued*

3. Significant Accounting Policies, *continued*

Bonds and Equity Securities, *continued*

Bonds are rated and valued in accordance with the NAIC Securities Valuation Office (SVO) rating guidelines. Bonds with a SVO rating of 1 and 2 are valued at amortized cost. Bonds with a SVO rating of 3 or higher are valued at the lower of cost or market. Bond amortization is calculated using the straight-line method. In accordance with SSAP 26, bond amortization shall be calculated using the scientific (constant yield) interest method. MSF is not able to obtain this information from its fund manager at this time. Management believes the difference between the straight-line method and the scientific method is immaterial to the current year Statutory Statements of Revenue and Expenses and Changes in Equity and is not able to determine the cumulative impact to the Statutory Statements of Admitted Assets, Liabilities and Equity. MSF has no derivative investments.

Premium Receivable – Premium receivable balances with an amount due over 90 days are non-admitted assets. The MSF evaluates the remaining admitted accounts receivable asset for impairment. If it is probable that any amounts are not collectible, the uncollectible receivable is written off and charged to income in the period the determination is made.

Risks and Uncertainties – Risks and uncertainties existing as of the date of the financial statements, are as follows:

Use of Estimates – The preparation of financial statements in conformity with Statutory Accounting Principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the period. Actual results could differ from those estimates.

Credit Risk – Credit risk is defined as the risk that an issuer or other counterparty to an investment will not fulfill its obligation. With the exception of the U.S. Government securities, fixed income instruments have credit risk as measured by major credit rating services. This risk is that the issuer of a fixed income security may default in making timely principal and interest payments. The Board of Investment's policy requires MSF fixed income investments, at the time of purchase, to be rated an investment grade as defined by Moody's and/or Standard & Poor's (S&P) rating services. The U.S. Government securities are guaranteed directly or indirectly by the U.S. Government. Obligations of the U.S. Government or obligations explicitly guaranteed by the U.S. Government are not considered to have credit risk.

continued

NOTE A – ORGANIZATION, BASIS OF PRESENTATION, AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, *continued*

3. Significant Accounting Policies, *continued*

Risk and Uncertainties, *continued*

Custodial Credit Risk - Custodial credit risk for investments is the risk that, in the event of the failure of the counterparty to a transaction, a government will not be able to recover the value of the investment or collateral securities that are in the possession of an outside party. As of June 30, 2006 and 2005, all the fixed income and other equity securities were registered in the nominee name for the Montana Board of Investments and held in the possession of the Board's custodial bank, State Street Bank.

Concentration of Credit Risk - Concentration of credit risk is the risk of loss attributed to the magnitude of a government's investment in a single issuer. The MSF Investment Policy requires credit risk to be limited to 3% in any one name except AAA rated issued will be limited to 6%. The MSF Investment Policy provides for "no limitation on U.S. government/agency securities." Investments issued or explicitly guaranteed by the U.S. government are excluded from the concentration of credit risk requirement.

Interest Rate Risk - Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. MSF investment policies do not formally address interest rate risk, however the Board has selected the effect duration method to calculate interest rate risk. This information is provided by the custodial bank.

Corporate asset-backed securities are based on cash flows from principal and interest payments on underlying auto loan receivables, credit card receivables, and other assets. These securities, while sensitive to prepayments due to interest rate changes, have less credit risk than securities not backed by pledged assets.

MSF investments are categorized in Note B to disclose credit and interest rate risk as of June 30, 2006 and 2005.

Losses Incurred and LAE Reserves - Losses incurred and loss adjustment expense (LAE) reserves are established to provide for the estimated ultimate settlement cost of all claims incurred. Management believes that the reserves for unpaid losses and loss adjustment expenses are adequate; however, there can be no assurance that the ultimate settlement of losses may not vary materially from the estimate recorded. Since liabilities are based on estimates, the ultimate liability may be in excess of, or less than, the amounts provided. Adjustment to these estimates of reserves will be reflected in the Statutory Statement of Revenue and Expenses in future years.

continued

NOTE A – ORGANIZATION, BASIS OF PRESENTATION, AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, *continued*

3. Significant Accounting Policies, *continued*

Risk and Uncertainties, *continued*

Uncertainty Due to Litigation - In the ordinary course of business, MSF is a defendant in various litigation matters. Although there can be no assurances, as of June 30, 2006 and 2005, in the opinion of MSF's management based on information currently available, the ultimate resolution of these legal proceedings would not be likely to have a material adverse effect on its statutory results of revenue and expenses, admitted assets, liabilities and equity or liquidity. For further discussion, refer to Note J (Contingencies, Uncertainties and Subsequent Events).

Vulnerability Due to Certain Concentrations - MSF uses approximately 38 agencies located throughout Montana to market workers' compensation policies with gross written premiums of \$235.3M for the year ended June 30, 2006. MSF conducts its business within the State of Montana for the most part and is susceptible to risk based on the economy of the geographic territory it serves.

Administrative Cost Allocation - State law requires MSF to separately determine and account for administrative expenses and benefit payments for claims for injuries resulting from accidents occurring before July 1, 1990 (Old Fund) from those occurring on or after July 1, 1990 (MSF). The law also limits annual administrative costs of claims associated with the Old Fund to \$1.25M in fiscal years 2006 and 2005, respectively. The Montana State Fund allocated \$1.25M in administration costs to the Old Fund in fiscal years 2006 and 2005, respectively. The Old Fund has a \$576K (thousand) contingent obligation to the Montana State Fund in unrecovered administrative costs incurred in fiscal years prior to 2003, which is not recorded in these financial statements. MSF intends to recover this amount in future years in which the cost of administering the Old Fund is less than the statutorily permitted \$1.25M.

Electronic Computer Equipment and Software - Electronic computer equipment is recorded at cost and depreciated on a straight-line basis over an estimated useful life of three years. Computer equipment and software are capitalized if the actual or estimated historical cost exceeds \$5,000. Software is amortized on a straight-line basis using a three-year life for operating software and a five-year life for application software. In accordance with statutory accounting principles, electronic computer equipment and operating software are admitted assets. Application software is a non-admitted asset.

Furniture, Equipment and Leasehold Improvements - Furniture and equipment are capitalized if the cost exceeds \$5,000, and are recorded at cost and depreciated on a straight-line basis using estimated useful lives, which range from five to ten years. There are no leasehold improvements. Statutory accounting principles require that furniture, equipment and leasehold improvements be capitalized, depreciated and non-admitted.

continued

NOTE A – ORGANIZATION, BASIS OF PRESENTATION, AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, *continued*

3. Significant Accounting Policies, *continued*

Other Assets – Other assets include advances, prepaid expenses, customer deposits and reinsurance funds withheld.

Losses Incurred and Loss Adjustment Expense Estimates – Loss and loss adjustment expense (LAE) reserves are established to provide for the estimated ultimate settlement cost of all claims incurred. Loss reserves are based on reported aggregate claim cost estimates combined with estimates for future development of such claim costs and estimates of incurred but not reported (IBNR) claims. Tillinghast-Towers Perrin, an external actuarial firm, prepares an actuarial study used to estimate liabilities and the ultimate cost of settling claims reported but not settled and IBNR as of June 30, 2006 and 2005. The study provides a range of potential cost associated with the reported claims, the future development of those claims and IBNR. MSF management has selected the best estimates within that range as the estimated loss reserves. Because actual claim costs depend on such complex factors as inflation and changes in the law, claim liabilities are recomputed periodically using a variety of actuarial and statistical techniques to produce current estimates that reflect recent settlements, claim frequency, and other economic and social factors.

A provision for inflation and the calculation of estimated future claim costs is implicit in the calculation because reliance is placed both on actual historical data that reflect past inflation and on other factors that are considered to be appropriate modifiers of past experience. As of June 30, 2006 and 2005, \$590.7M and \$511.6M, respectively, of unpaid claims and claim adjustment expenses are presented at face value net of estimated reinsurance recoverable.

Reinsurance Recoverables on Paid and Unpaid Losses – Reinsurance recoverables are estimates of paid and unpaid losses collectible from MSF's reinsurers. The amounts ultimately collected may be more or less than these estimates. Any adjustments of these estimates are reflected in revenues and expenses, as they are determined.

Deferred Revenue – Deferred revenue reflects amounts billed or received in advance, but not yet earned for policies effective July 1, 2006 and 2005, respectively.

Other Liabilities consist of:

- **Security Deposits** – Security deposits are monies held on behalf of certain insured's due to their loss ratios and payment histories as well as due to particular payment terms. In addition, funds withheld in accordance with the reinsurance contract are also included in this account.

continued

NOTE A – ORGANIZATION, BASIS OF PRESENTATION, AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, *continued*

3. Significant Accounting Policies, *continued*

- **Accounts Payable** – Accounts payable includes liabilities incurred on behalf of claimants, refunds due to policyholders and amounts due to vendors.
- **Compensated Absences** – MSF supports two leave programs, the State of Montana Leave Program and the MSF Personal Leave Program, implemented in January 2002. The State of Montana Leave Program covers all employees represented by the union. Union represented employees accumulate both annual leave and sick leave and MSF pays employees 100% of unused annual leave and 25% of unused sick leave upon termination. MSF also pays 100% of unused compensatory leave credits upon termination to nonexempt employees. MSF Personal Leave Program covers all non-union employees. Non-union employees accumulate personal leave and extended leave. MSF pays employees 100% of unused personal leave upon termination but extended leave has no cash value at the time of termination. MSF absorbs expenses for termination pay in its annual operational costs. MSF had a total leave accrued liability of \$2.0M and \$1.8M at June 30, 2006 and 2005, respectively.

Income Taxes Payable– MSF is a component unit of the State of Montana and is not subject to Federal or State premium or income tax.

Premium Revenue – Premiums are recognized as revenue on a pro-rata basis over the policy period, beginning on the effective date of the policy. MSF's Board of Directors approves premium rates annually.

Policyholders are contractually obligated to pay certain premiums to MSF in advance of the period in which the premiums are earned. Advance premiums are deferred until the effective date of the policy at which time they are recognized as revenue on a pro-rata basis over the term of the policy. Premium advances are refundable when the policyholder's coverage is canceled and MSF has credited all earned premiums.

Expenses incurred in connection with acquiring new insurance business, including such acquisition costs as sales commissions, are charged to operations as incurred.

Policyholder Dividends – The amount of dividends to be paid to policyholders is determined annually by MSF's Board of Directors. The aggregate amount of policyholders' dividends is related to the financial results for the year and to the appropriate level of statutory equity to be retained by MSF.

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Notes to the Statutory Financial Statements
June 30, 2006 and 2005

NOTE B - INVESTMENTS

The investments of MSF as of June 30, 2006 and 2005 are as follows:

<u>June 30, 2006</u>	<u>Total Investment Holdings</u>	<u>Percentage</u>
Bonds:		
U.S. Government Issuer Obligations	\$ 283,499,013	31.5%
Special Revenue and Special Assessment Obligations	20,208,115	2.3%
Public Utilities	11,943,181	1.3%
Industrial and Miscellaneous Unaffiliated Issuer Obligations	272,849,011	30.3%
Industrial and Miscellaneous Other Multi-Class Commercial Mortgage-Backed/Asset-Backed Securities	80,199,120	8.9%
Total Bonds	668,698,440	74.3%
Unaffiliated Publicly Traded Equity Securities	83,377,362	9.3%
Cash and Short-Term Investments	14,919,072	1.7%
Other Invested Assets	132,438,892	14.7%
Total Invested Assets	<u>\$899,433,766</u>	<u>100.0%</u>
<u>June 30, 2005</u>	<u>Total Investment Holdings</u>	<u>Percentage</u>
Bonds:		
U.S. Government Issuer Obligations	\$227,334,614	29.3%
Special Revenue and Special Assessment Obligations	26,134,547	3.4%
Public Utilities	11,932,994	1.5%
Industrial and Miscellaneous Unaffiliated Issuer Obligations	221,777,407	28.6%
Industrial and Miscellaneous Other Multi-Class Commercial Mortgage-Backed/Asset-Backed Securities	78,671,484	10.1%
Total Bonds	565,851,046	72.9%
Unaffiliated Publicly Traded Equity Securities	76,737,097	9.9%
Cash and Short-Term Investments	32,157,356	4.1%
Other Invested Assets	101,859,456	13.1%
Total Invested Assets	<u>\$776,604,955</u>	<u>100.0%</u>

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Notes to the Statutory Financial Statements
June 30, 2006 and 2005

NOTE B - INVESTMENTS, *continued*

The amortized cost and market value of securities as of June 30, 2006 are as follows:

June 30, 2006	Amortized Cost	Gross Unrealized		Market Value
		Gain	Loss	
Bonds:				
U.S. Government Issuer Obligations	\$283,499,013	\$939,660	\$7,222,702	\$277,215,971
Special Revenue/Assessment Obligations	20,208,115	21,769	319,525	19,910,359
Public Utilities	11,943,181	360,256	261,282	12,042,155
Industrial and Miscellaneous Unaffiliated Issuer Obligations	274,258,013	744,082	9,459,422	265,542,673
Ind. And Misc. Commercial Unaffiliated Mortgage-Backed/Asset-Backed Securities	80,199,120	1,457,103	887,171	80,769,052
Subtotal	670,107,442	<u>\$3,522,870</u>	<u>\$18,150,102</u>	655,480,210
Bond Write Down due to SVO Rating	(1,409,002)			-
Total Bonds	<u>\$668,698,440</u>			<u>\$655,480,210</u>
Unaffiliated Publicly Traded Equity Securities	<u>\$68,406,676</u>	<u>\$14,970,686</u>	<u>\$ -</u>	<u>\$83,377,362</u>

The amortized cost and market value of securities as of June 30, 2005 are as follows:

June 30, 2005	Amortized Cost	Gross Unrealized		Market Value
		Gain	Loss	
Bonds:				
U.S. Government Issuer Obligations	\$227,334,614	\$5,572,240	\$628,853	\$232,278,001
Special Revenue/Assessment Obligations	26,134,547	782,711	-	26,917,258
Public Utilities	11,932,994	951,968	-	12,884,962
Industrial and Miscellaneous Unaffiliated Issuer Obligations	221,777,407	4,325,440	2,107,539	223,995,308
Ind. And Misc. Commercial Unaffiliated Mortgage-Backed/Asset-Backed Securities	79,458,930	4,857,434	1,099,971	83,216,393
Subtotal	566,638,492	<u>\$16,489,793</u>	<u>\$3,836,363</u>	579,291,922
Bond Write Down due to SVO Rating	(787,446)			-
Total Bonds	<u>\$565,851,046</u>			<u>\$579,291,922</u>
Unaffiliated Publicly Traded Equity Securities	<u>\$68,406,676</u>	<u>\$8,330,421</u>	<u>\$ -</u>	<u>\$76,737,097</u>

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Notes to the Statutory Financial Statements
June 30, 2006 and 2005

NOTE B - INVESTMENTS, *continued*

The amortized cost and estimated market value of MSF's fixed maturity securities as of June 30, 2006 and 2005 are shown below at contractual maturity. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

<u>June 30, 2006</u>	<u>Carrying Value</u>	<u>Market Value</u>
Due one year or less (excludes STIP)	\$59,987,159	\$59,692,577
Due after one year through five years	345,047,861	338,447,216
Due after five years through ten years	216,052,865	209,755,675
Due after ten years	47,610,555	47,584,742
Totals	<u>\$668,698,440</u>	<u>\$655,480,210</u>

<u>June 30, 2005</u>	<u>Carrying Value</u>	<u>Market Value</u>
Due one year or less (excludes STIP)	\$18,584,037	\$18,737,683
Due after one year through five years	308,240,497	313,083,127
Due after five years through ten years	172,312,176	177,837,490
Due after ten years	66,714,336	69,633,622
Totals	<u>\$565,851,046</u>	<u>\$579,291,922</u>

During fiscal year ending June 30, 2006 MSF realized gross gains from sales of securities of \$443K and gross realized losses of \$698K. During fiscal year ending June 30, 2005 MSF realized gross gains from sales of securities of \$1.1M and gross realized losses of \$77K.

Supplemental Investment Risk Information

MSF's largest ten exposures to a single issuer/borrower/investment, listed by investment category (excluding U.S. government-related securities) are:

<u>June 30, 2006</u>	<u>Amount</u>	<u>Percentage of Total Admitted Assets</u>
Industrial and Miscellaneous Other Multi-Class Commercial MB/AB	\$11,040,622	1.178%
Industrial and Miscellaneous Other Multi-Class Commercial MB/AB	10,000,000	1.067%
Industrial and Miscellaneous Unaffiliated Issuer Obligations	9,972,223	1.064%
Industrial and Miscellaneous Unaffiliated Issuer Obligations	9,967,858	1.063%
Industrial and Miscellaneous Other Multi-Class Commercial MB/AB	9,727,139	1.038%
Industrial and Miscellaneous Other Multi-Class Commercial MB/AB	8,181,000	0.873%
Industrial and Miscellaneous Other Multi-Class Commercial MB/AB	6,861,082	0.732%
Industrial and Miscellaneous Unaffiliated Issuer Obligations	6,587,293	0.703%
Industrial and Miscellaneous Unaffiliated Issuer Obligations	5,243,764	0.559%
Industrial and Miscellaneous Unaffiliated Issuer Obligations	5,220,776	0.557%

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Notes to the Statutory Financial Statements
June 30, 2006 and 2005

NOTE B - INVESTMENTS, *continued*

<u>June 30, 2005</u>	Percentage of Total	
	<u>Amount</u>	<u>Admitted Assets</u>
Industrial and Miscellaneous Other Multi-Class Commercial MB/AB	\$12,384,215	1.545%
Industrial and Miscellaneous Other Multi-Class Commercial MB/AB	9,968,673	1.243%
Industrial and Miscellaneous Unaffiliated Issuer Obligations	9,961,684	1.242%
Industrial and Miscellaneous Unaffiliated Issuer Obligations	9,955,983	1.242%
Industrial and Miscellaneous Other Multi-Class Commercial MB/AB	9,545,000	1.190%
Industrial and Miscellaneous Other Multi-Class Commercial MB/AB	7,925,967	0.988%
Industrial and Miscellaneous Other Multi-Class Commercial MB/AB	7,337,858	0.915%
Industrial and Miscellaneous Unaffiliated Issuer Obligations	5,365,479	0.669%
Industrial and Miscellaneous Unaffiliated Issuer Obligations	5,261,827	0.656%
Industrial and Miscellaneous Unaffiliated Issuer Obligations	5,112,572	0.638%

The amounts and percentages of MSF's total admitted assets held in bonds by NAIC ratings are:

<u>June 30, 2006</u>	<u>Amount</u>	Percentage of Total
		<u>Admitted Assets</u>
NAIC-1	\$596,982,576	63.676%
NAIC-2	53,097,948	5.664%
NAIC-3	18,617,916	1.986%
Total Bonds	<u>\$668,698,440</u>	<u>71.325%</u>

<u>June 30, 2005</u>	<u>Amount</u>	Percentage of Total
		<u>Admitted Assets</u>
NAIC-1	\$482,232,700	60.142%
NAIC-2	74,260,901	09.262%
NAIC-3	9,357,445	01.167%
Total Bonds	<u>\$ 565,851,046</u>	<u>70.571%</u>

MSF investments are categorized below to disclose credit and interest rate risk as of June 30, 2006 and 2005. Credit risk reflects the bond quality rating, by investment type, as of the June 30 report date. If a bond investment type is unrated, the quality type is indicated by NR (not rated). Interest rate risk is disclosed using effective duration. Both the credit quality ratings and duration have been calculated excluding cash equivalents.

Credit Quality Rate and Effective Duration as of June 30, 2006 are:

<u>Security Investment Type</u>	<u>Fair Value</u>	<u>Credit Quality Rating</u>	<u>Effective Duration</u>
Corporate Bonds (Rated)	\$341,731,816	A	3.91
U.S. Government Direct-Backed	33,644,312	AAA	5.54
U.S. Government Indirect-Backed	293,322,312	AAA	3.33
Total Fixed Income Investments	<u>\$668,698,440</u>	AA-	3.74

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Notes to the Statutory Financial Statements
June 30, 2006 and 2005

NOTE B - INVESTMENTS, *continued*

Credit Quality Rate and Effective Duration as of June 30, 2005 was:

<u>Security Investment Type</u>	<u>Fair Value</u>	<u>Credit Quality Rating</u>	<u>Effective Duration</u>
Corporate Bonds (Rated)	\$ 299,185,736	A	4.84
U.S. Government Direct-Backed	17,805,771	AAA	7.45
U.S. Government Indirect-Backed	248,859,539	AAA	3.67
Total Fixed Income Investments	<u>\$ 565,851,046</u>	AA-	4.39

NOTE C - CASH COLLATERAL AND LIABILITY FOR SECURITIES ON LOAN

Under the provisions of state statutes, the Montana Board of Investments (BOI) has, by a Securities Lending Authorization Agreement, authorized the custodial bank, State Street Bank, to lend BOI's securities to broker-dealers and other entities with a simultaneous agreement to return the collateral for the same securities in the future. During the period the securities are on loan, BOI receives a fee and the bank must initially receive collateral equal to 102% of the market value of the securities on loan and must maintain collateral equal to not less than 100% of the market value of the loaned security. BOI retains all rights of ownership during the loan period.

The cash collateral received on each loan was invested, together with the cash collateral of other qualified plan lenders, in a collective investment pool, the Securities Lending Quality Trust. The relationship between the average maturities of the investment pool and BOI's loans was affected by the maturities of the loans made by other plan entities that invested cash collateral in the collective investment pool, which BOI could not determine. On June 30, 2006 and June 30, 2005, BOI had no credit risk exposure to borrowers.

The following table presents the carrying and market values of the securities on loan and the total collateral held as of June 30, 2006 and 2005:

	<u>2006</u>	<u>2005</u>
Securities on Loan - Book Value	\$ 130,560,457	\$ 115,170,586
Securities on Loan - Market Value	130,023,855	120,193,821
Total Cash Collateral Held	132,438,892	101,859,456
Total Non-Cash Collateral Held	-	20,650,000

NOTE D - CASH AND SHORT-TERM INVESTMENTS

MSF participates in the Short-Term Investment Pool (STIP) maintained by BOI. STIP balances are highly liquid investments. There are no legal risks that BOI is aware of regarding STIP investments. The market value of STIP approximates cost.

continued

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Notes to the Statutory Financial Statements
June 30, 2006 and 2005

NOTE D - CASH AND SHORT-TERM INVESTMENTS, *continued*

The STIP investments' credit risk is measured by investment grade ratings given individual securities. BOI's policy requires that STIP investments have the highest rating in the short-term category by one and/or any Nationally Recognized Statistical Rating Organizations (NRSRO). The four NRSRO's include Standard and Poor's, Moody's Investors Service, Fitch, Inc. and Dominion Bond Rating Service Ltd.

Cash and short-term investments at June 30, 2006 and 2005 consist of:

	2006	2005
Change fund	\$ 50	\$ 50
Cash in bank	2,522,906	2,678,229
Scholarship fund	-	16,500
STIP investment	12,396,116	29,462,577
	<u>\$ 14,919,072</u>	<u>\$ 32,157,356</u>

NOTE E - EQUIPMENT, NET

Equipment and software are recorded at cost net of accumulated depreciation and admitted or non-admitted in accordance with statutory accounting principles as follows:

	Computer Equipment and Operating Software	Furniture and Office Equipment	Application Software	Total
<u>June 30, 2006</u>				
Assets	\$ 3,234,208	\$ 647,157	\$ 13,619,046	\$ 17,500,411
Accumulated Depreciation	1,968,069	363,843	8,943,540	11,275,452
Net Assets Non-admitted	-	283,314	4,675,506	4,958,820
Net Assets Admitted	1,266,139	-	-	1,266,139
Depreciation Expense	483,848	67,348	711,162	1,262,358

	Computer Equipment and Operating Software	Furniture and Office Equipment	Application Software	Total
<u>June 30, 2005</u>				
Assets	\$ 2,338,243	\$ 650,492	\$ 9,251,364	\$ 12,240,099
Accumulated Depreciation	1,551,570	426,943	8,232,377	10,210,890
Net Assets Non-admitted	-	223,549	1,018,987	1,242,536
Net Assets Admitted	786,673	-	-	786,673
Depreciation Expense	538,026	59,972	573,473	1,171,471

continued

NOTE E - EQUIPMENT, NET, *continued*

Building - The 1981 Legislature appropriated funds for the construction of the Workers' Compensation building. As of July 1, 1990, MSF transferred the value of the building from its records to the Department of Administration, which owns most other state buildings. Under the agreement, MSF pays all costs associated with the building, including utilities, property taxes, janitorial services, and maintenance.

NOTE F - LOSSES INCURRED AND LOSS ADJUSTMENT RESERVES

Losses incurred and loss adjustment expense (LAE) reserves are established to provide for the estimated ultimate settlement cost of all claims incurred. Losses incurred reserves are based on reported aggregate claim cost estimates combined with estimates for future development of such claim costs and estimates of incurred but not reported (IBNR) claims.

Tillinghast-Towers Perrin, an external actuarial firm, prepares an actuarial study used to estimate liabilities and the ultimate cost of settling claims reported but not settled and IBNR as of June 30, 2006 and 2005. The study provides a range of potential cost associated with the reported claims, the future development of those claims and IBNR. MSF management has selected the best estimates within that range as the estimated loss reserves. Because actual claim costs depend on such complex factors as inflation and changes in the law, claim liabilities are recomputed periodically using a variety of actuarial and statistical techniques to produce current estimates that reflect recent settlements, claim frequency, and other economic and social factors.

Management believes that the reserves for unpaid losses and loss adjustment expenses are adequate; however, there can be no assurance that the ultimate settlement of losses may not vary materially from the estimate recorded. Since liabilities are based on estimates, the ultimate liability may be in excess of, or less than, the amounts provided. Adjustment to these estimates of reserves will be reflected in the Statutory Statement of Revenue and Expenses and Changes in Equity in future years.

The following analysis provides a reconciliation of the activity in the reserve for losses and loss adjustment expenses.

	Years Ended June 30,	
	2006	2005
At beginning of year:		
Net reserves for losses and loss expenses	\$ 511,557,000	\$ 452,115,000
Losses and loss expenses incurred:		
Current year	170,398,933	164,830,093
Prior years	35,439,091	7,900,824
Total	205,838,024	172,730,917
Losses and loss expenses paid:		
Current year	(36,131,780)	(38,341,972)
Prior years	(90,575,244)	(74,946,945)
Total	(126,707,024)	(113,288,917)
Total losses and loss adjustment expenses at end of the year	<u>\$ 590,688,000</u>	<u>\$ 511,557,000</u>

continued

NOTE G – RETIREMENT PLANS, DEFERRED COMPENSATION AND POSTRETIREMENT PLANS

MSF and its employees contribute to the Public Employees Retirement System (PERS), which offers two types of retirement plans administered by the Public Employees' Retirement Board (PERB). The first plan is the Defined Benefit Retirement Plan (DBRP), a multiple-employer, cost-sharing plan that provides retirement, disability and death benefits to plan members and their beneficiaries. Benefits are based on eligibility, years of service and highest average compensation. Vesting occurs once membership service totals five years. Benefits are established by state law and can only be amended by the legislature.

The second plan is the Defined Contribution Retirement Plan (DCRP), created by the 1999 legislature and available to all active PERS members effective July 1, 2002. This plan is a multiple-employer, cost-sharing plan that also provides retirement, disability and death benefits to plan members and their beneficiaries. Benefits are based on the balance in the member's account, which includes the total contributions made, the length of time the funds have remained in the plan and the investment earnings less administrative costs.

Eligible PERS members choose to participate in either the DBRP or DCRP but may not be active members of both plans. MSF and its employees are required to contribute 6.9% of annual compensation in fiscal years 2006 and 2005. MSF's contributions amounted to \$1.0M for fiscal year 2006 and \$867K for fiscal year 2005. MSF and its employees paid one hundred percent of required contributions to PERS and there is no unpaid liability as of June 30, 2006.

MSF and its employees are eligible to participate in the State of Montana Deferred Compensation Plan (457 plan) administered by the PERB. The Deferred Compensation plan is a voluntary, tax-deferred retirement plan designed as a supplement to other retirement plans. Under the plan, eligible employees elect to defer a portion of their salary until future time periods. MSF incurs no costs for this plan.

NOTE H – POLICYHOLDERS' DIVIDENDS

During fiscal year 2006 and 2005, the MSF's Board of Directors authorized and paid dividends to policyholders of record of \$5.0M and \$5.0M during policy years 2004 and 2003, respectively.

NOTE I – REINSURANCE ASSUMED AND CEDED

For the fiscal years ended June 30, 2006 and June 30, 2005 MSF ceded reinsurance to other reinsurance companies to limit the exposure arising from large losses. These arrangements consist of excess of loss contracts that protect against occurrences over stipulated amounts and an aggregate stop loss contract. The excess of loss contracts provide coverage of \$95.0M for both fiscal years 2006 and 2005. During fiscal years 2006 and 2005, MSF retained the first \$5.0M for the first layer of reinsurance coverage. Individual, per person coverage was provided up to \$5.0M per any one individual loss for both fiscal years 2006 and 2005.

NOTE I – REINSURANCE ASSUMED AND CEDED, *continued*

The term of the current aggregate stop loss contract is July 1, 2005 through June 30, 2008. The contract provides coverage based on MSF's premium levels at a maximum of \$33.8M per year and a minimum of \$28.5 but in aggregate not to exceed 80% of the sum of the annual limits for all contract years. In the event reinsurers are unable to meet their obligations under either the excess of loss contracts or aggregate stop loss contract, MSF would remain liable for all losses, as the reinsurance agreements do not discharge MSF from its primary liability to the policyholders.

Premium revenue is reduced by premiums paid for reinsurance coverage of \$13.6M and \$6.8M in fiscal years 2006 and 2005, respectively. The aggregate stop loss contract requires that MSF maintain a funds withheld account which represents the basic premium portion of the total premium paid for aggregate stop loss coverage. The funds withheld account at June 30, 2006 and 2005 are \$17.0M and \$7.8M, respectively. Interest must be accrued quarterly at an annual rate of 5.0% on the funds withheld account for fiscal year 2006 and 6.5% for fiscal year 2005, resulting in accrued interest of \$1.0M for fiscal year 2006 and \$547K for fiscal year 2005.

During fiscal years 2006 and 2005, estimated claim reserves were reduced \$10.0M for the amount of reinsurance estimated to be ultimately recoverable on incurred losses due to the Excessive Loss Reinsurance contract. In fiscal year 2006, estimated claim reserves were reduced by an additional \$2.9M for the amount of reinsurance estimated to be ultimately recoverable on incurred losses due to the Aggregate Stop Loss contract.

MSF also has assumed reinsurance relationships with Argonaut Insurance Company, Fireman's Fund Insurance Company and Legion Insurance Company related to Other States Coverage (OSC). MSF assumes risk for OSC claims, which are then covered under MSF's ceded reinsurance contract. Assumed premium for fiscal years 2006 and 2005 is \$2.5M and \$2.7M, respectively. The assumed liability for OSC claims is \$2.9M for fiscal year 2006 and \$2.4M for fiscal year 2005.

NOTE J – CONTINGENCIES AND UNCERTAINTIES

Stavenjord v. State Compensation Insurance Fund. The first *Stavenjord* decision was issued by the Workers' Compensation Court on May 22, 2001. It addressed the issue of whether the failure of the Occupational Disease Act (ODA) to provide PPD (permanent partial disability) benefits equivalent to the benefits provided in the Montana WCA (workers' compensation act) violates the claimant's right to equal protection of the law. Relying on the *Henry* case (previous case from the Supreme Court finding that vocational rehabilitation benefits must also be paid under the ODA), the court held that MCA §39-72-405 is unconstitutional as applied to Debra Stavenjord. "Where PPD benefits calculated pursuant to the WCA are greater than the benefits available to a claimant under the ODA, constitutional equal protection guarantees require that benefits be computed and paid in accordance with the WCA. The claimant in this case is entitled to \$27,027 under the WCA, versus \$10,000 under the ODA." The Montana Supreme Court affirmed the case on April 1, 2003. On August 27, 2004 the Workers' Compensation Court held that *Stavenjord* is retroactive to June 3, 1999 (the date of the *Henry* decision). The Court held that a common fund was created for claimants reaching Maximum Medical Improvement on or after June 3, 1999. The cost of retroactively paying benefits for claims in the period of June 3, 1999 through May 21, 2001, is estimated at \$2.2 million and was recorded in the loss reserves of the financial statements. There was no impact on the Old Fund liability with this ruling. The decision was appealed to the Montana Supreme Court.

continued

NOTE J - CONTINGENCIES AND UNCERTAINTIES, *continued*

The Montana Supreme Court issued their decision on the appeal on October 6, 2006, holding that a common fund was not created. The court also held that the decision applies retroactively to claims from July 1, 1987. The cost to retroactively pay claims to July 1, 1987 was estimated at \$14 to \$19 million dollars for the Montana State Fund (New Fund- for claims on or after July 1, 1990). The impact on the Old Fund liability for claims that occurred from July 1, 1987 to June 30, 1990 was estimated at \$5 to \$7 million. As the Supreme Court held that claims closed by either court order or settlement are excluded, and the cost estimates above included these claims, the estimates will be reduced. Revised cost estimates have not yet been completed. Actual cost impact is unknown.

Schmill v. Liberty Northwest Insurance. This case, 2003 MT 80, decided April 10, 2003 by the Montana Supreme Court held as follows, "We conclude that the ODA and the WCA treat similarly situated classes of workers differently. Furthermore, apportioning Schmill's permanent impairment award for her occupational disease pursuant to §39-72-706, MCA, of the ODA while providing full benefits for injured workers pursuant to the WCA is not rationally related to a legitimate governmental interest. Therefore, we conclude that §39-72-706, MCA, violates the equal protection guarantee found at Article II, Section 4 of the Montana Constitution. The judgment of the Workers' Compensation Court is affirmed." The Workers' Compensation Court determined that a common fund existed and the case was retroactive to July 1, 1987. This decision was affirmed on appeal to the Montana Supreme Court. The June 7, 2005 decision of the Montana Supreme Court created a common fund and applied the decision retroactively. The cost is estimated to be \$1.4 to \$1.9 million dollars for MSF. The decision of the Montana Supreme Court is estimated to impact the Old Fund liability in the amount of \$800,000 for claims that occurred before July 1, 1990. This was not a case against the Montana State Fund, but the holding of this decision applies to Montana State Fund and the Old Fund. Implementation and retroactively issues are presently before the Workers' Compensation Court. This case is recorded in loss reserves.

Wild v. Fregein and Montana State Compensation Insurance Fund, 2003 MT 115, decided April 29, 2003, primarily held that §39-71-401(3), MCA, does not, as a matter of law, conclusively preclude any factual inquiry into whether an employer/employee relationship exists once the worker has been issued the exemption contemplated by §39-71-401(3), MCA., and "that §39-71-401(3), MCA, read in conjunction with §39-71-120, MCA, does require the employer to make an initial good faith inquiry of the worker to determine that he or she does, in fact, meet the control and independently established business tests before the employer employs the worker as an IC [Independent Contractor] and if the employer determines the worker is an IC, to thereafter treat the worker as an IC and not as an employee as Fregein treated Wild in this case." The case was heard in conjunction with a similar case filed against Liberty Northwest, *Mathews v. Liberty Northwest*. Retroactive application of the *Wild* decision and its status as a common fund is presently before the Workers' Compensation Court in on-going litigation. The Workers' Compensation Court did however issue a decision in *Mathews v. Liberty Northwest*, holding that the case was not retroactive and a common fund not created. The Worker's Compensation Court on June 1, 2005 ruled in remand on the issue of retroactivity and held that the decision should be retroactive. The *Mathews* case was appealed to the Montana Supreme Court, but was dismissed on October 7, 2005. As data on identification of potential claims is difficult to identify, no analysis of cost estimates on retroactive application of the decision is available at this time and final disposition is unknown. The probable outcome of litigation creating a cost impact on Montana State Fund is remote.

continued

NOTE J – CONTINGENCIES AND UNCERTAINTIES, *continued*

Satterlee v. Lumberman's Mutual Casualty Company et al., WCC No. 2003-0840, was filed before the Workers' Compensation Court on July 18, 2003. The *Satterlee vs. Lumberman's Mutual Casualty Company* case challenges the constitutionality of state statute, (39-71-710, MCA) passed by the Montana Legislature in 1981. That statute authorizes termination of permanent total disability benefits and rehabilitation benefits when a claimant receives or becomes eligible to receive full Social Security retirement benefits or an alternative to that plan. Should the statute be found to be unconstitutional as applied to permanent total benefits, *Satterlee, et al.* request payment of lifetime permanent total disability benefits. In addition, the petition requests certification of this case as a class action or the establishment of a common fund for similarly situated claimants. Petitioners filed a motion and brief for summary judgment on the constitutional issue. The Worker's Compensation Court provided an opportunity for any workers' compensation insurer to intervene until June 6, 2005. The Workers' Compensation Court issued a decision on December 12, 2005, holding that Section 39-71-710, MCA is constitutional as applied to Permanent Total Disability benefits. A motion requesting reconsideration was filed by petitioner and granted in part. These issues on reconsideration have been fully briefed. It is likely that the case will be appealed to the Montana Supreme Court. Should 39-71-710, MCA ultimately be held to be unconstitutional as applied to permanent total disability benefits by the Montana Supreme Court, and also found to apply retroactively, the cost impact has been estimated for non-settled claims arising on or after July 1, 1990 through December 22, 2004 at \$135 million to \$186 million. The estimated cost of retroactively applying the decision to the Old Fund, for non-settled permanent total disability claims that occurred before July 1, 1990 is \$93 to \$116 million. The potential for liability for MSF and the state of Montana is reasonably possible. Actual cost impact is unknown.

Reesor v. Montana State Fund, 2004 MT 370. *Reesor* was receiving social security retirement benefits at the time he suffered an industrial accident. He received an impairment award but was denied other permanent partial disability (PPD) benefits pursuant to section 39-71-710, MCA which provides that persons who are receiving social security benefits or are eligible for full social security retirement benefits are ineligible for PPD benefits other than an impairment award. *Reesor* challenged the constitutionality of section 39-71-710, MCA, on equal protection grounds and sought full PPD benefits. On July 26, 2003, the Workers' Compensation Court found 39-71-710, MCA, to be constitutional. *Reesor* appealed to the Montana Supreme Court, where on December 22, 2004, the Court held that limiting *Reesor's* permanent partial benefit pursuant to 39-71-710, MCA, violated the Equal Protection Clause of the Montana Constitution. Pending before the Workers' Compensation Court is the retroactive application of the decision and common fund status. MSF has estimated the cost of benefits associated with a retroactive application of *Reesor*. MSF's estimate did not include claims with entitlement dates occurring on or after July 1, 1991 through June 30, 1995 because the *Russette* decision appears to make *Reesor* inapplicable during that timeframe. Excluding the *Russette* timeframe, for claims arising on or after July 1, 1990 through December 22, 2004, the increase in benefits costs for MSF is estimated at \$2.0 million. For claims arising on or after July 1, 1987 through June 30, 1990, the retroactive application of *Reesor* will result in an estimated benefit cost increase of \$1.0 million for the Old Fund. The potential for the litigation to create a liability for MSF and the state of Montana is reasonably possible. Actual cost impact, should decision be applied retroactively, is unknown.

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Notes to the Statutory Financial Statements
June 30, 2006 and 2005

NOTE K – EQUITY – NON-ADMITTED ASSETS AND RECONCILIATION TO GAAP

The following is an accounting of non-admitted assets for the years ended June 30, 2006 and 2005:

	2006	2005
Balance of non-admitted assets – beginning of year	\$ 7,385,026	\$ 5,274,317
Increase (decrease) in non-admitted assets:		
Change in premiums receivable	(203,847)	(607,762)
Change in short-term notes and loans receivable	11,126	4,341
Change in bond downgrades	621,556	366,358
Change in net tangible assets	59,765	(20,966)
Change in intangible assets	1,371,595	2,537,986
Change in property held in trust	153,519	306,216
Change in other assets	281,075	(475,464)
Net increase (decrease) in non-admitted assets	2,294,789	2,110,709
Balance of non-admitted assets – end of year	<u>\$ 9,679,815</u>	<u>\$ 7,385,026</u>

The following schedule reconciles statutory equity calculated in accordance with NAIC SAP to Net Assets as determined by governmental accounting principles generally accepted in the United States of America at June 30:

	2006	2005
Statutory Equity (NAIC SAP)	\$ 163,101,495	\$ 148,353,871
Add:		
Non-admitted assets as shown above	9,679,815	7,385,026
Change in investment value of bonds to fair market value	(13,218,230)	13,440,876
Less the portion of the change in investment value recognized for GAAP	(1,409,002)	(787,446)
The change in net income between NAIC SAP and GAAP for:		
Deferred acquisition costs	(569,570)	282,274
Reversal of small adjustment and other	1	-
Net assets (GAAP)	<u>\$ 157,584,509</u>	<u>\$ 168,674,601</u>

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INDEPENDENT AUDITORS' REPORT

To the Audit Committee of the
Board of Directors
Montana State Fund
Helena, Montana

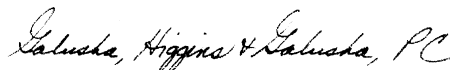
We have audited the accompanying statutory statements of admitted assets, liabilities and equity of Montana State Fund, a component unit of the State of Montana, at June 30, 2006 and 2005, and the related statutory statements of revenue and expenses, changes in equity and cash flows for the years then ended. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform our audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described more fully in Note A to the financial statements, Montana State Fund prepared these financial statements in conformity with accounting practices prescribed or permitted by the Insurance Department of Montana, which practices differ from accounting principles generally accepted in the United States of America. The effects on the financial statements of the variances between statutory accounting practices and accounting principles generally accepted in the United States of America are described in Note K.

In our opinion, the financial statements referred to in the first paragraph present fairly, in all material respects, the admitted assets, liabilities, and equity (statutory basis) of Montana State Fund for the years ended June 30, 2006 and 2005, and results of its operations, changes in equity and cash flows (statutory basis) for the years ended June 30, 2006 and 2005 on the basis of accounting described in Note A.

However, because the company prepares its financial statements on a statutory basis of accounting, as discussed in the preceding paragraph, it is our opinion, that the financial statements referred to above do not present fairly, in conformity with accounting principles generally accepted in the United States of America, the financial position of Montana State Fund for the years ended June 30, 2006 and 2005 or the results of its revenue and expenses, changes in equity and cash flows for the years then ended.



GALUSHA, HIGGINS AND GALUSHA, PC
Certified Public Accountants and Advisors

Helena, Montana
December 21, 2006

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December 8, 2006

To The Board of Directors of the Montana State Fund:

The Tillinghast business of Towers Perrin was engaged by the Montana State Fund (MSF) to estimate the unpaid loss and loss adjustment expenses as of June 30, 2006, for MSF's workers' compensation exposures. Our examination included the performance of independent projections of MSF's loss and loss expense liabilities and such other tests and procedures as we considered necessary in the circumstances. We relied on MSF personnel as to the completeness and accuracy of the data.

The midpoint of our range of estimated loss and loss adjustment expense liability as of June 30, 2006, is \$566.9 million, undiscounted, and net of reinsurance recoverables. MSF has recorded a provision of \$590.7 million on its June 30, 2006 balance sheet for net unpaid loss and loss adjustment expense. MSF's recorded provision of \$590.7 million is within our estimated range of the liability for net unpaid loss and loss adjustment expense.

In our opinion, the amounts recorded in the balance sheet as reserves for estimated loss and loss adjustment expense liabilities: (1) Are consistent with amounts calculated in accordance with commonly accepted actuarial methods and are fairly stated on an ultimate undiscounted basis in accordance with the *Statement of Principles Regarding Property and Casualty Loss and Loss Adjustment Expense Reserves* adopted by the Casualty Actuarial Society; (2) Are consistent with amounts based upon actuarial assumptions which are reasonable given the coverages provided; and (3) Make good and sufficient provision in the aggregate for all unpaid loss and loss adjustment expense obligations.

The Equity of MSF as of June 30, 2006, is \$163.1 million, using statutory accounting principles. Current fiscal year (July 1, 2005 to June 30, 2006) premium revenue was \$211.9 million. We note that the Equity level of MSF is consistent with traditional industry standards. We believe that it is prudent for MSF to set a long-term goal of maintaining appropriate equity based on industry standards.

VARIABILITY

Loss and loss adjustment expense reserve estimates are subject to considerable uncertainty due to the fact that the ultimate liability for claims is subject to the outcome of events yet to occur. In evaluating whether the reserves make a reasonable provision for unpaid losses and loss expenses, it is necessary to project future loss and loss adjustment expense payments. Actual future losses and loss adjustment expenses will not develop exactly as projected and may, in fact, vary significantly from the projections.



Robert F. Conger
Fellow, Casualty Actuarial Society
Member, American Academy of Actuaries



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